

**QUALITY
CONTROL
REVIEW
REPORT**

**ERNST & YOUNG LLP AND DEFENSE
CONTRACT AUDIT AGENCY AUDIT OF
SOUTHWEST RESEARCH INSTITUTE, FISCAL
YEAR ENDED SEPTEMBER 24, 1999**

January 23, 2002



National Aeronautics and
Space Administration

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Acronyms

AICPA	American Institute of Certified Public Accountants
CAM	Contract Audit Manual
CPSR	Contractor Purchasing System Review
DCAA	Defense Contract Audit Agency
DCMC	Defense Contract Management Command
DCMA	Defense Contract Management Agency
DLA	Defense Logistics Agency
DOD	Department of Defense
GAAP	Generally Accepted Accounting Principles
GAGAS	Generally Accepted Government Auditing Standards
MRD	Memorandum from Regional Director
NASA	National Aeronautics and Space Administration
OIG	Office of Inspector General
OMB	Office of Management and Budget
SOP	Statement of Position
SwRI	Southwest Research Institute

Office of Inspector General

January 23, 2002

Mr. Francis Summers, Regional Director
Central Region
Defense Contract Audit Agency
6321 Campus Circle Drive East
Irving, TX 75063-2742

Re: Final Report on the Quality Control Review of Ernst & Young LLP and Defense
Contract Audit Agency Audit of Southwest Research Institute for the Fiscal Year
Ended September 24, 1999, Assignment No. A-01-015-00
Report Number IG-02-007

Dear Mr. Summers:

The subject final report is provided for your use. Please refer to the Executive Summary for the overall review results. Our evaluation of your response is incorporated into the body of the report. The Defense Contract Audit Agency's (DCAA's) comments on a draft of this report were responsive to the recommendations. The DCAA's planned and completed actions are sufficient to close recommendations 1 through 3 and 5 through 7 for reporting purposes.

If you have questions concerning the report, please contact Mr. Chester A. Sipsock, Program Director, Financial Management Audits, Quality, and Oversight, at (216) 433-8960, or Ms. Vera J. Garrant, Auditor-in-Charge, at (202) 358-2596. We appreciate the courtesies extended to the audit staff. The final report distribution is in Appendix I.

Sincerely,

[original signed by]

Alan J. Lamoreaux
Assistant Inspector General for Audits

Enclosure

cc:

AB/Associate Deputy Administrator for Institutions

B/Acting Chief Financial Officer

B/Comptroller

BF/Director, Financial Management Division

G/General Counsel

H/Associate Administrator for Procurement

JM/Director, Management Assessment Division

Mr. Jerry McAfee, Branch Manager, Arlington Branch Office, Defense
Contract Audit Agency

Office of Inspector General

January 23, 2002

Mr. Jack S. Fernandi, Controller
Southwest Research Institute
6220 Culebra Road
San Antonio, TX 78228

Re: Final Report on the Quality Control Review of Ernst & Young LLP and Defense
Contract Audit Agency Audit of Southwest Research Institute for the Fiscal Year
Ended September 24, 1999, Assignment No. A-01-015-00
Report Number IG-02-007

Dear Mr. Fernandi:

The subject final report is provided for your use. Please refer to the Executive Summary for the overall review results. Our evaluation of your response is incorporated into the body of the report. Your comments on the draft of this report were responsive, and your planned corrective action for future audits is sufficient to close recommendation 4 for reporting purposes.

If you have questions concerning the report, please contact Mr. Chester A. Sipsock, Program Director, Financial Management Audits, Quality, and Oversight, at (216) 433-8960, or Ms. Vera J. Garrant, Auditor-in-Charge, at (202) 358-2596. We appreciate the courtesies extended to the audit staff. The final report distribution is in Appendix I.

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Alan J. Lamoreaux
Assistant Inspector General for Audits

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Mr. Jerry McAfee, Branch Manager, Arlington Branch Office, Defense
Contract Audit Agency

Contents

Executive Summary, i

Introduction, 1

Findings and Recommendations

Finding A. Internal Control Documentation and Testing, 2

Finding B. Reporting Results of the Assist Audit, 8

Finding C. Relying on the Work of Others to Test Procurement and Suspension and Debarment, 12

Finding D. Opinion on the Schedule of Expenditures of Federal Awards, 16

Finding E. Internal Auditors' Documentation of Internal Control Tests, 19

Appendix A – Single Audit Requirements, 22

Appendix B – Objectives and Scope, 25

Appendix C – Quality Control Review Methodology, 27

Appendix D – Follow-up on Department of Defense Office of Inspector General Finding and Recommendation, 29

Appendix E – Other Matters of Interest, 31

Appendix F – Defense Contract Audit Agency Response, 33

Appendix G – Southwest Research Institute Response, 38

Appendix H – OIG Comments on Defense Contract Audit Agency Response, 39

Appendix I – Report Distribution, 41

NASA Office of Inspector General

IG-02-007
A-01-015-00

January 23, 2002

Ernst & Young LLP and Defense Contract Audit Agency Audit of Southwest Research Institute for the Fiscal Year Ended September 24, 1999

Executive Summary

Background. The Southwest Research Institute (SwRI), San Antonio, Texas, is a non-profit research and development organization dedicated to technology development and transfer for applied engineering and physical sciences.

The Department of Defense (DOD) is the cognizant audit agency for SwRI. The DOD Office of Inspector General (OIG) granted the National Aeronautics and Space Administration (NASA), a Federal funding agency to SwRI, permission to perform a quality control review of the Ernst & Young LLP and Defense Contract Audit Agency (DCAA) audit of SwRI's fiscal year ended September 24, 1999.¹ The Single Audit Act and the Single Audit Act Amendments² require the audit. The SwRI reported total fiscal year Federal expenditures of about \$34.7 million for NASA and total direct Federal expenditures of about \$139.2 million.

Appendix A provides details on the Single Audit requirements.

Review Objectives. We reviewed the Office of Management and Budget (OMB) Circular A-133 audit report and supporting working papers for the SwRI audit for the fiscal year ended September 24, 1999.

- **Audit Report Review.** The objective of our report review was to determine whether the report that the SwRI submitted to the Federal Audit Clearinghouse³ for fiscal year 1999 met the applicable reporting standards and OMB Circular A-133⁴ reporting requirements.

¹The San Antonio, Texas, office of Ernst & Young LLP and the DCAA SwRI suboffice performed the single audit for the SwRI fiscal year ended September 24, 1999.

²Office of Management and Budget Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," implements the requirements of the Single Audit Act and the Single Audit Act Amendments. Appendix A contains details on the requirements of the Circular.

³The Single Audit Act Amendments of 1996, §7504(c), require the Office of Management and Budget to establish the Federal Audit Clearinghouse to receive the Circular A-133 audit reports.

⁴ See footnote 2.

- **Working Paper Review.** The objectives of our quality control review were to determine whether Ernst & Young LLP and DCAA conducted the fiscal year 1999 audit in accordance with applicable standards and whether the audit met the auditing and reporting requirements of OMB Circular A-133. Appendixes B and C contain details on the objectives, scope, and methodology.
- **Follow-up on Prior Findings.** We also determined whether Ernst & Young LLP and DCAA completed corrective action related to the findings identified in the September 11, 1998, DOD OIG report number PO 98-6-017, “Quality Control Review of Ernst & Young LLP and the Defense Contract Audit Agency, Southwest Research Institute, Fiscal Year Ended September 27, 1996.” Appendix D contains details on our follow-up of the DOD OIG findings and recommendation.
- **Quality Control Review Scope Limitation.** The \$139.2 million of Federal expenditures included \$13.8 million of classified awards,⁵ which represented about 10 percent of total Federal expenditures. None of the classified awards were NASA-funded; therefore, we did not include those awards as part of our review. Our opinion is, therefore, limited to our review of the DCAA SwRI suboffice audit, excluding classified awards. For the Ernst & Young LLP audit, we limited our review to accounts receivable, accounts payable, and other related areas such as management representations and assessment of misrepresentations related to fraud and litigation. See Finding B for a further discussion of the DCAA audit of classified awards.

Results of Audit. The Ernst & Young LLP auditors were responsible for auditing the SwRI financial statements. On October 29, 1999, Ernst & Young LLP issued its audit report on SwRI for the fiscal year ended September 24, 1999.

The DCAA auditors were responsible for auditing the research and development major program. On August 28, 2000, DCAA issued its report on compliance and internal control for SwRI for fiscal year 1999. The DCAA report also included an opinion on the Schedule of Expenditures of Federal Awards.⁶

- **Reported A-133 Results.** The Ernst & Young LLP auditors (1) identified no findings, (2) questioned no costs, and (3) issued an unqualified opinion⁷ on the financial statements. The auditors also found no instances of noncompliance in the financial statement audit that are required to be reported under generally accepted

⁵ Classified awards are contracts, grants, and cooperative agreements that relate to national security.

⁶ The Schedule of Expenditures of Federal Awards reports the total expenditures for each Federal program for the period covered by the auditee’s financial statements.

⁷An unqualified opinion means that the financial statements are presented fairly in all material respects; expenditures of Federal funds are presented fairly in relation to the financial statements taken as a whole; and the auditee has complied with all applicable laws, regulations, and contract provisions that could have a direct and material effect on each major program.

government auditing standards (GAGAS).⁸ Finally, the auditors noted no matters involving internal controls relating to the financial statements that are considered to be material weaknesses.⁹

The DCAA auditors (1) identified a finding, (2) questioned costs, (3) issued an unqualified opinion on the Schedule of Expenditures of Federal Awards, and (4) issued a qualified opinion¹⁰ on major program compliance. The auditors qualified their opinion on major program compliance because they could not audit the classified awards (see Finding B for further details). The auditors also noted no matters involving internal controls relating to the major program that they considered to be material weaknesses.

- **Report Quality Review Results.** SwRI's audit report meets the applicable reporting guidance and regulatory requirements in OMB Circular A-133.
- **Audit Quality Review Results.** The Ernst & Young LLP audit work met the applicable auditing guidance and requirements in OMB Circular A-133 and its related Compliance Supplement, GAGAS, and generally accepted auditing standards.

The DCAA audit work did not meet the applicable auditing guidance and requirements in OMB Circular A-133 and its related Compliance Supplement, GAGAS, and generally accepted auditing standards. Overall, Federal agencies and other users could not rely on the audit report because the DCAA auditors did not do the following:

- Document and test internal controls for certain compliance requirements. Consequently, report users had no basis to rely on the audit report assurances related to internal controls (Finding A).
- Qualify the report to explain that only a portion of the classified awards was not audited. As a result, report users may have mistakenly believed that none of the classified awards were audited (Finding B).

⁸These standards are broad statements of the auditors' responsibilities promulgated by the Comptroller General of the United States.

⁹The American Institute of Certified Public Accountants (AICPA) Statement of Position 98-3, Appendix D, defines a material weakness as:

... a condition in which the design or operation of one or more of the internal control components [control environment, risk assessment, control activities, information and communication, and monitoring] does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

¹⁰A qualified opinion means that, except for the effects of the matters related to the qualification, the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each major program.

- Document reliance on the work of others for the procurement and suspension and debarment compliance requirement.¹¹ Therefore, report users could not rely on the auditors' opinion that SwRI complied with the requirement (Finding C).
 - Document working papers to support the opinion on the Schedule of Expenditures of Federal Awards. Consequently, report users could not rely on the auditors' opinion that the Schedule of Expenditures of Federal Awards is materially stated in relation to the financial statements taken as a whole (Finding D).
 - Verify that the SwRI internal auditors' working papers adequately documented internal control testing. As a result, report users had no basis to rely on the audit report assurances related to internal controls (Finding E).
- **Prior Quality Control Review Follow-up Results.** The Ernst & Young LLP auditors completed the recommended corrective action to issue a report that addresses internal controls and compliance in accordance with GAGAS at the financial statement level and to refer to GAGAS in the audit report for fiscal year 1999. The DCAA audit report accurately describes the compliance requirements tested. In addition, DCAA completed the self-imposed corrective action to obtain training related to OMB Circular A-133. Appendix D of our report contains details on our follow-up of the DOD OIG findings and recommendation.

Other Matters of Interest. During the report and quality control reviews, we identified issues related to reporting and working paper documentation that should be brought to SwRI and DCAA management's attention but did not affect the results of our review. These issues are discussed in Appendix E.

Recommendations. We recommended that for the fiscal year 1999 and future years' audits, DCAA qualify its report for Federal awards that were not audited.

We also recommended that the Regional Director, Central Region, DCAA require its auditors to document their working papers for the reconciliation between the Schedule of Expenditures of Federal Awards, the incurred cost submission, and the financial statements when performing an OMB Circular A-133 audit to opine on the Schedule of Expenditures of Federal Awards.

Finally, we recommended that for future audits, SwRI coordinate the audit responsibilities for the OMB Circular A-133 audit through its cognizant agency for audit.

We had planned to recommend that for the fiscal year 1999 audit, DCAA perform the necessary auditing procedures to support its opinion on the Schedule of Expenditures of Federal Awards and to ensure that the SwRI internal auditors adequately document their working papers for the internal control testing performed. However, the auditors completed corrective action during our quality control review. Therefore, this report has no recommendations to address those findings.

¹¹Appendix A lists the 14 compliance requirements.

We had also planned to recommend that for the fiscal year 1999 audit, DCAA document the working papers and permanent files for the auditors' understanding of internal control, perform internal control testing, qualify its report for Federal awards that were not audited, and perform an audit of the procurement and suspension and debarment compliance requirement or determine the extent of reliance that DCAA can place on the work that the Defense Logistics Agency performed related to this requirement. However, the auditors completed corrective action for these recommendations subsequent to our quality control review, but prior to our issuance of the draft of this report. Therefore, this final report has no recommendations to address those findings.

DCAA's Response. The DCAA working paper documentation can be improved to better document internal controls and the reconciliation of the Schedule of Expenditures of Federal Awards to the accounting records, financial statements, and incurred cost submission. DCAA issued a supplemental audit report, which included the assist audit results and revised the qualification to identify the awards that DCAA did not audit. Although the DCAA auditors did not adequately document their working papers, they followed DCAA guidance on evaluating and using the work of Government technical specialists to document the reliance placed on the Defense Contract Management Agency's (DCMA) review of SwRI's purchasing system. Finally, the auditors had reviewed the SwRI Internal Audit Department's internal control working papers to determine the extent to which DCAA can rely on the SwRI's work. However, the internal auditors' working paper documentation could be improved. DCAA will ensure that future-year audits at SwRI include procedures to address the fiscal year 1999 findings and recommendations. The complete text of the DCAA response is in Appendix F.

SwRI's Response. SwRI agreed for future years' audits to contact its cognizant agency for audit to coordinate the required audit activities and responsibilities among the audit organizations. The complete text of the SwRI response is in Appendix G.

Evaluation of Management Responses. DCAA submitted additional working papers and a supplemental audit report to our office in response to the draft of this report. During our field work, we found that the DCAA working papers did not adequately document the auditors' understanding of and the testing related to internal controls. After our field work, the auditors included additional working paper documentation and revised the existing internal control documentation to allow an independent reviewer to understand the work performed. The additional and revised working papers adequately document the auditors' understanding of internal controls.

The DCAA guidance on using the work of Government specialists requires the auditors to review the specialists' audit report to understand the work performed and the degree of reliance the auditors should have on the technical evaluation. The DCAA auditors ensured that the specialists' scope of work included the procurement compliance requirement. However, the specialists' report does not state that the review was

performed to meet the OMB Circular A-133 audit requirements. Therefore, DCAA had no assurance that the work was performed as required by OMB Circular A-133 until the auditors reviewed the DCMA working papers that support the report.

DCAA's completed corrective action for the 1999 audit and planned corrective actions on future years' audits meet the intent of the recommendations. Therefore, all of the recommendations directed to DCAA are closed, and report users can rely on the information contained in the 1999 audit report. DCAA also provided general comments related to the contents of the draft report (see Appendix H).

SwRI's planned corrective action for future years' audits meets the intent of the recommendation. Therefore, the related recommendation is also closed for reporting purposes.

Introduction

The Single Audit Act Amendments of 1996 (Public Law 104-156) and the June 24, 1997, revision to OMB Circular A-133 require that an auditee obtain an annual audit of its fiscal year Federal expenditures. The audit must be performed by independent auditors and must be in accordance with the Single Audit Act Amendments of 1996, OMB Circular A-133 and its related Compliance Supplement, and the GAGAS applicable to financial audits.

A complete reporting submission in accordance with OMB Circular A-133 includes the following: (1) financial statements and related opinion, (2) Schedule of Expenditures of Federal Awards and related opinion, (3) report on internal controls and compliance review on the financial statements, (4) report on internal control review and compliance opinion on major programs, and a (5) Schedule of Findings and Questioned Costs.¹²

Appendix A contains additional details on the Single Audit requirements.

¹²Appendix C describes the information in the Schedule of Findings and Questioned Costs.

Findings and Recommendations

Finding A. Internal Control Documentation and Testing

The DCAA auditors did not adequately document their understanding of or test internal controls for the activities allowed or unallowed, allowable costs/cost principles, and equipment and real property management compliance requirements. This occurred because, instead of obtaining an independent understanding of the internal control system at SwRI, the auditors used the standardized DCAA checklist. The auditors also did not maintain the supporting information to demonstrate their understanding of internal controls related to the compliance requirements audited. Without this information to support the auditors' conclusions and judgments related to the nature and extent of internal control testing, report users had no basis to rely on the audit report assurances related to internal controls. After our quality control review but before issuance of our draft report, DCAA auditors completed corrective action for the current year's audit by revising and including additional working paper documentation for their understanding of and testing related to internal controls. Therefore, report users can now rely on the audit report assurances related to internal controls for the activities allowed or unallowed, allowable costs/cost principles, and equipment and real property management compliance requirements.

Working Paper Documentation Requirements

The American Institute of Certified Public Accountants (AICPA) Codification of Statements on Auditing Standards §339.05, "Content of Working Papers," and GAGAS, sections 4.34 through 4.37, "Working Papers," require auditors to retain a record of the audit in the form of working papers to demonstrate that the applicable standards of field work have been met. GAGAS further state that the form and content of the working papers should allow an experienced auditor to understand the auditor's significant conclusions and judgments. In general, the working papers should document the objectives, scope, and methodology, including the sampling criteria the auditors used. Specifically, working papers should include enough information about the work performed and the documents (transactions and records) examined so that an experienced auditor would be able to examine the same documents and understand the auditors' judgments and conclusions.

Internal Control Requirements

In general, OMB Circular A-133 §___500(c) requires an auditor to perform procedures to obtain an understanding of internal controls over Federal programs that is sufficient to plan the audit for major programs and to plan and perform internal control testing. The AICPA Statement of Position (SOP) 98-3, "Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards," sections 8.7, 8.10, and 8.16, describe the auditor's responsibilities for planning the review of internal controls for major programs. The auditor must obtain a sufficient understanding of internal control

over Federal programs by performing procedures to understand the design of the five internal control components¹³ related to the A-133 compliance requirements for each major program. The auditor must also determine whether the internal controls are operating effectively. The auditor plans the internal control testing to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. SOP 98-3, section 8.16, explains:

... [F]ederal agencies want to know if conditions indicate that auditees have not implemented adequate internal control over compliance for federal programs to ensure compliance with applicable laws and regulations.

The OMB Circular A-133 Compliance Supplement, Part 6, provides guidance on reviewing the five components of internal controls for each type of compliance requirement. The information in the Supplement is intended to assist non-Federal entities and their auditors in complying with the internal control requirements by describing the objectives of internal controls and certain characteristics that, when present and operating effectively, may ensure compliance with the program requirements.

Auditors must assess control risk for the assertions related to Circular A-133 compliance requirements for each major program and then perform the planned testing. The Supplement does not provide suggested audit procedures because of the diverse internal control systems among Federal award recipients. Therefore, auditors must determine the appropriate internal control procedures.

DCAA Internal Control Documentation and Testing

The auditors did not adequately document the working papers for or test internal controls for the activities allowed or unallowed, allowable costs/cost principles, and equipment and real property management compliance requirements. The DCAA auditors used the internal control section of the agency's OMB Circular A-133 standard working papers to support the documentation and testing of internal controls. The standard DCAA working papers include an internal control checklist, which states that the auditors are to answer the checklist questions and include supporting references. The instructions on how to complete the checklist also state that there may be other internal control characteristics not identified in the checklist and that every question in the checklist may not be applicable to the organization audited. The standard DCAA checklist could be used as a starting point; however, it does not provide for situations in which an organization's internal controls are different from the characteristics identified in the yes/no checklist. The instructions also do not provide guidance on how the auditors should describe other internal control characteristics that are not identified in the checklist.

For each of the 14 compliance requirements, the checklist contains yes/no questions for the 5 components of internal control. The checklist also requires the auditors to test internal controls for each question with a "yes" answer. A "yes" answer indicates that

¹³ The five components of internal control are the control environment, risk assessment, control activities, information and communication, and monitoring.

the internal control is present at the organization. If the auditors use the standard DCAA checklist every year, then for each “yes” answer, the auditors will test the same control rather than identify and test the controls they will rely on in the current year audit. In addition, this approach does not include testing for other internal controls the auditors identified that are not part of the standard yes/no checklist.

For each compliance requirement, the DCAA auditors prepared a summary working paper that referenced other working papers that support the auditors’ internal control documentation and testing. In the section related to documentation, the auditors stated their conclusions on internal controls. For example, some conclusions were that the controls are “inadequate in part” or “moderate.” In the section for testing, the auditors referenced other supporting working papers for the current assignment or that had been completed as part of other assignments. The referenced working papers, however, are only checklists, which do not provide further explanations to justify the “yes” or “no” responses.

Internal Control Documentation. The auditors relied on other assignments, policies and procedures, permanent files, and their cyclical review of the SwRI accounting systems to support their internal control documentation and testing for the compliance requirements. However, the auditors did not describe the internal controls related to their responses in the yes/no checklist. For example, the auditors answered “yes” to the following control environment question related to the equipment and real property management compliance requirement:

Is management committed to providing proper stewardship for property acquired with federal awards?

The auditors did not explain how proper stewardship was accomplished or who in management provided stewardship for the property. In addition to the yes or no response, the auditors included a reference to support their answer, but those references were generally to other assignments or to SwRI policies, procedures, or manuals. As a result, the independent reviewer would need to read the entire audit file, policy, procedure, or manual to understand the response to the internal control characteristic. Because the internal control documentation is not sufficient, the independent reviewer might understand the auditors’ responses in the DCAA internal control checklist only by researching, reviewing, and analyzing every reference in the checklist.

Internal Control Testing. The auditors did not perform any internal control testing for the fiscal year 1999 audit and did not complete the checklist sections related to internal control testing. Rather, the DCAA auditors relied on the cyclical internal control reviews that were performed in prior years as support for the fiscal year 1999 internal control tests. Relying on cyclical reviews that were not performed in FY 1999 does not meet the OMB Circular A-133 requirement to perform internal control testing on an annual basis.

Use of Cyclical Reviews in A-133 Audits. As part of its internally required audit procedures, DCAA performs cyclical reviews of the auditee's internal control systems. DCAA may use those reviews as the basis for documenting and testing internal controls under the A-133 audit assignments and maintain the reviews in DCAA's permanent files on the auditee. However, the auditor must ensure the cyclical reviews include documentation that addresses the A-133 compliance requirements. Maintaining the internal control documentation for each compliance requirement in permanent files would require the auditors to update the documentation annually and ensure, through such procedures as observation and inquiry, that the same internal controls are still in place and operating effectively. The auditor would perform testing or other auditing procedures, as appropriate, to determine whether the controls are current.

We identified similar findings related to documentation and testing during a quality control review of the DCAA working papers supporting the OMB Circular A-133 audit of the Smithsonian Institution. Based on the Smithsonian review, we recommended that DCAA document its working papers for the auditors' understanding of internal controls. The DCAA corrective action approach was to document the permanent files for the auditors' understanding of the internal controls related to each of the 14 compliance requirements that are applicable and material to the research and development major program, which is the only major program at the Smithsonian. As applicable, the auditors used the cyclical DCAA internal control reviews to support their understanding of internal controls for each compliance requirement. The auditors identified the internal controls they intended to rely on and test based on their documented understanding. For the years DCAA has not scheduled a cyclical review related to a particular compliance requirement, the auditors will determine whether the information in the permanent files is current and that it accurately reflects the current system of internal control for the compliance requirement. If the controls are not current, the auditors will revise the permanent file documentation accordingly. We concluded that the auditors' corrective actions met the intent of our report recommendations.

Effect on the Audit

Without sufficient documentation of the auditors' understanding of internal controls, we could not fully understand the support for the auditors' conclusions and judgments regarding the nature and extent of internal control or compliance testing. In addition, reviewers will not be able to determine that the review of internal control was adequately planned and executed for each compliance requirement to meet the OMB Circular A-133 audit objectives.

Without sufficient documentary evidence of the internal control tests, the independent reviewer had no basis to rely on the SwRI internal controls. Further, Federal agencies and other SwRI report users could not rely on the audit report's assurance that internal controls are in place and operating effectively for the major programs that are identified in the audit report.

We planned to recommend that for the fiscal year 1999 audits of SwRI, the Regional Director, Central Region, Defense Contract Audit Agency:

- Require auditors to document their working papers for an understanding of the five components of internal control for the activities allowed or unallowed, allowable costs/cost principles, and equipment and real property management compliance requirements so that an independent reviewer can understand the internal controls the auditors' relied on and tested.
- Plan and perform internal control testing for the activities allowed or unallowed, allowable costs/cost principles, equipment and real property management compliance requirements as required by OMB Circular A-133.

However, the auditors completed corrective action for the audit after our quality control review, but before issuance of the draft report. Therefore, we consider corrective action sufficient, and the recommendations do not address work performed in the current year's audit related to internal control documentation and testing.

Recommendations, Management Response, and Evaluation of Response

We recommend that for each of the compliance requirements that has a direct and material effect on the major program in future audits of SwRI, the Regional Director, Central Region, Defense Contract Audit Agency:

- 1. Require auditors to document their working papers for an understanding of the five components of internal control so that an independent reviewer can understand the internal controls the auditors' relied on and tested.**
- 2. Plan and perform internal control testing as required by OMB Circular A-133.**

DCAA's Response. Concur. The DCAA SwRI suboffice obtained an independent understanding of the internal control system and performed the necessary testing of relevant internal controls prior to the OIG quality control review. The working papers could be improved to better document the steps taken to obtain an understanding of and test internal controls. DCAA improved the working paper documentation by summarizing the relevant internal controls relied on and ensured that the working paper references were more specific.

For future years' audits at SwRI, DCAA will ensure that the working papers adequately document the auditor's understanding and testing of internal controls for applicable compliance requirements.

The complete text of the response is in Appendix F.

Evaluation of Management's Response. We reviewed the additional and revised DCAA working paper documentation that identifies the internal controls DCAA relied on and tested in the current years' audit. We found that as revised and supplemented, the working papers currently provide adequate documentation of the DCAA work performed. Therefore, we concur with the DCAA statement that the auditors had already performed internal control testing before the quality control review, but that the testing had not been adequately documented to allow an independent reviewer to understand the work performed. DCAA's completed corrective actions are responsive to the recommendations and are sufficient to close the recommendations for reporting purposes.

DCAA's general comments related to Finding A and our responses are in Appendix H.

Finding B. Reporting Results of the Assist Audit

The DCAA audit report qualification did not accurately describe the scope limitation related to an assist audit requested from the DCAA Field Detachment¹⁴ and did not state that other awards not audited by the Field Detachment must be audited. This occurred because the auditors did not incorporate the results of the DCAA Field Detachment audit into the final report. As a result, the audit report may lead Federal agencies and other report users to mistakenly believe that DCAA did not audit any of the \$13.8 million in classified awards. Based on the current report qualification, Federal agencies may believe that they must obtain an audit of their classified awards, and, therefore, some classified awards may be audited twice.

Auditing Requirements and Reporting Guidance

Major Program Audit Requirements. OMB Circular A-133 requires an audit of the major programs that the auditors determine to be high risk. Based on the OMB Circular A-133 § ____.520 risk analysis, the DCAA auditors determined that research and development is the only major program at SwRI. All expenditures in the Schedule of Expenditures of Federal Awards are for research and development. Therefore, there is only one major program, and all of the research and development expenditures are subject to audit. In general, OMB Circular A-133 § ____.500(c)(1) and (2) require the auditors to obtain a sufficient understanding of internal controls to plan the audit and to determine the nature, timing, and extent of internal control testing to support at least a low level of control risk for major programs. OMB Circular A-133 § ____.500(d)(1) and (4) and AICPA SOP 98-3 require the auditors to determine whether the Federal award recipient complied with the laws, regulations, and contract and grant provisions that materially affect the major program. Compliance testing includes transaction testing and other auditing procedures that provide the auditors with sufficient evidence to support an opinion on compliance.

DCAA Auditing and Reporting Guidance. On October 28, 1998, DCAA issued guidance in the Memorandum from Regional Director (MRD) 98-PIC 150(R), “Audit Guidance on Limitation of Audit Scope When Performing an OMB Circular A-133 Audit.” In general, the MRD states that the DCAA regional field audit offices should request assistance from the Field Detachment when the Schedule of Expenditures of Federal Awards identifies classified expenditures. The Field Detachment is responsible for coordinating with other Federal audit agencies to obtain an audit of the agencies’ classified awards and to report the results to the regional field audit office, which includes the suboffices. The guidance also states that DCAA field audit offices will rely on the work of other DCAA offices, including the Field Detachment, without identifying those offices in an audit report. Further, the DCAA Contract Audit Manual, Chapter 4-1000, Section 10, “Relying Upon the Work of Others,” paragraph 4-1002a, states: “Work

¹⁴The DCAA Field Detachment is responsible for auditing and reviewing classified awards.

performed by another DCAA auditor is to be presumed of sufficient quality based on DCAA's managerial controls." The reporting section of MRD 98-PIC 150(R) further advises the auditors:

Restrictions on the scope of the DCAA field audit office's work on compliance may require the auditor to express a qualified opinion or disclaim of opinion. For example, the circumstances may be that DCAA's portion of the coordinated audit of Federal programs does not include the entirety of the auditee's Federal awards, the excluded awards are significant, and the exclusions impact the auditor's ability to form an overall opinion on compliance over the Federal program. These circumstances may occur ... when the Field Detachment is precluded from applying all the procedures considered necessary to rely upon the work of another government audit organization. In such cases, DCAA's audit report will be revised as follows:

- The circumstances should be identified in a separate paragraph of DCAA's Circular A-133 audit reports, however, no mention will be made that any awards are classified.
- Both the *Scope* and *Results of Audit* paragraphs in the audit reports ... should specifically refer to this limitation on scope, and the audit opinion will refer only to those awards listed in DCAA's audit report.

DCAA Audit

The DCAA audit scope included all of the expenditures in the Schedule of Expenditures of Federal Awards. The \$13.8 million of expenditures identified in the Schedule as "selected" are classified; therefore, the suboffice auditors could not audit the direct costs associated with the selected awards. The classified awards are about 10 percent of the expenditures in the Schedule. The DCAA SwRI suboffice requested that the Field Detachment perform an audit of the selected awards. DCAA audited about \$7.3 million of the selected awards; the Field Detachment audited only about \$.5 million of direct costs, and the suboffice audited about \$6.8 million of the indirect costs. The Federal agencies that funded the remaining \$6.5 million of selected awards denied SwRI permission to grant the Field Detachment access to the information to perform the audit. In addition, the Federal agencies did not provide SwRI information about whether they or others audited the expenditures. As a result, neither the Field Detachment nor SwRI could provide assurance that the responsible Federal agencies audited or obtained audits on the remaining selected expenditures.

DCAA Audit Reports

The Field Detachment issued its report to the suboffice on August 15, 2000, and the DCAA SwRI suboffice issued its report on August 28, 2000. The DCAA Field Detachment states in the audit report that it performed the audit in accordance with OMB Circular A-133 and that the audit scope included the following compliance requirements: allowable costs/cost principles, period of availability of Federal funds, procurement and suspension and debarment, and special tests and provisions. The Field Detachment

auditors included a qualification for the selected awards they could not audit. The DCAA SwRI suboffice did not receive the Field Detachment report in time to include it in the overall DCAA audit report. However, the DCAA SwRI suboffice audit report included a qualification that the auditors did not audit any of the selected awards. The DCAA SwRI suboffice audit report does not state that the auditors requested an assist audit from the Field Detachment for the selected awards or that the audit for \$7.3 million (5 percent) of \$139.2 million of expenditures had been completed.

Effect on the Audit

Federal agencies and other report users rely on the reported opinion on compliance for each major program, as appropriate, based on an audit that is conducted in accordance with the requirements of OMB Circular A-133. Users also rely on the reported internal control assurances related to each major program. The report qualification did not state that the selected awards were part of an assist audit for which results had not been received or that only part of the classified awards was not audited. Therefore, based on the report qualification, Federal agencies and other report users may rely on the statement that the DCAA SwRI suboffice could not audit any of the classified expenditures. The report qualification could mislead Federal agencies to mistakenly believe that they must obtain an audit, causing classified awards to be audited twice.

Recommendations, Management Response, and Evaluation of Response

3. We recommend that for fiscal year 1999 and future audits, the Regional Director, Central Region, Defense Contract Audit Agency require auditors to comply with DCAA policy by:

- **Reporting the results on all the expenditures audited or including a qualification for the assist audit results not yet received as of the last day of field work.**
- **Qualifying the report for the selected awards that were not audited.**

4. We recommend that for future audits, the SwRI coordinate through its cognizant agency for audit the audit responsibilities of the Federal and non-Federal auditors to ensure that each Federal agency's classified awards have been audited.

DCAA's Response. Concur. The SwRI suboffice issued the initial report on August 28, 2000, and had not yet received the audit report from the Field Detachment. The initial report included a qualification on the awards not audited, but did not mention that the assist audit had not been received. DCAA issued a supplemental audit report on August 13, 2001, to incorporate the assist audit results that were received after August 28, 2000, and to update the qualification on awards not audited. DCAA provided a copy of the supplemental audit report to the NASA OIG office.

DCAA will ensure that future fiscal year audit reports at SwRI include appropriate qualifications on assist audits not received and awards that were not audited (see Appendix F).

SwRI's Response. Concur. SwRI agreed to contact its cognizant agency for audit to coordinate the required audit activities and responsibilities among the audit organizations. The complete text of the SwRI response is in Appendix G.

Evaluation of Management's Response. DCAA's completed corrective actions are responsive to the recommendations and are sufficient to close them for reporting purposes.

The SwRI planned corrective action for future years' audits meets the intent of the recommendation and is sufficient to close it for reporting purposes.

Finding C. Relying on the Work of Others to Test Procurement and Suspension and Debarment

The DCAA auditors did not adequately plan, execute, and document the annual review and test of the procurement and suspension and debarment compliance requirement¹⁵ to meet the OMB Circular A-133 audit requirement. This occurred because DCAA did not review the work of nonauditors who performed these tasks to determine whether the work was reliable. As a result, there was no basis to rely on the fiscal year 1999 procurement and suspension and debarment processes at SwRI and on the auditors' compliance opinion for the requirement. After our quality control review but before issuance of the draft report, DCAA auditors completed corrective action by reviewing the nonauditors' work and documenting the review in the auditors working papers. Therefore, report users can now rely on the audit report compliance opinion related to the procurement and suspension and debarment compliance requirement.

Procurement Audit Requirements

As discussed in Finding A, OMB Circular A-133 and AICPA SOP 98-3 require the auditors to document and test internal controls for each compliance requirement. The regulations also require auditors to determine compliance with the laws, regulations, and contract and grant provisions that materially affect the major program. Compliance testing includes tests of transactions and other auditing procedures to support an opinion on compliance. AICPA SOP 98-3, sections 6.36, 6.37, and 6.39, state that the purpose of the compliance testing is to provide the auditor with sufficient evidence to support an opinion on compliance for each major program and that the auditors should apply procedures to provide reasonable assurance of detecting material noncompliance.

Part 3, section I, of the Compliance Supplement provides the auditors guidance on reviewing compliance for the procurement requirement. The auditors must satisfy the audit objectives to determine compliance and may use the suggested audit procedures contained in the Supplement. The Compliance Supplement states that the auditors must determine whether:

1. Procurements were made in compliance with the provisions of the A-102 Common Rule, OMB Circular A-110, and other procurement requirements specific to an award.
2. The non-Federal entity obtained the required certifications for covered contracts and subawards.

Auditor Qualifications

OMB Circular A-133 §____.105 defines an auditor as "... a public accountant or a Federal, State or local government audit organization, which meets the general standards specified in GAGAS." GAGAS, Chapter 3, describes the following general standards for conducting financial and performance audits: staff qualifications, independence, due

¹⁵Appendix A lists the 14 compliance requirements.

professional care, and the presence of quality controls. In general, the audit organization has the responsibility to ensure that the staff conducting each audit collectively has the knowledge and skills necessary for that audit and that its staff maintains professional proficiency through continuing education and training. In addition, the audit organization and the individual auditors should be free from impairments to independence and should maintain an independent attitude and appearance in all matters related to the audit work. The auditors must perform the work with due professional care, which imposes a responsibility on each auditor to observe GAGAS. Finally, each audit organization conducting audits in accordance with these standards should have an appropriate internal quality control system in place and undergo an external quality control review at least once every 3 years. General standards apply to all audit organizations, both government and nongovernment that conduct audits of government organizations, programs, activities, and functions and of government assistance received by non-government organizations.

DCAA's Reliance on Nonauditors

The DCAA auditors determined that the procurement and suspension and debarment compliance requirement has a direct and material effect on the research and development program at SwRI. The DCAA auditors used the results of a procurement system review of SwRI that was performed by the DOD Defense Logistics Agency (DLA),¹⁶ an organization that does not meet the OMB Circular A-133 definition of an auditor. DLA reviewed and approved the SwRI procurement system and issued a report with its results on June 9, 2000. DLA did not perform the procurement system review in accordance with GAGAS. Therefore, DCAA should have reviewed the DLA procurement work to determine the extent to which DCAA may have relied on the DLA work to meet OMB Circular A-133 audit requirements. However, the DCAA auditors did not review the DLA organization to determine whether it met the OMB Circular A-133 auditor definition or whether the DLA work satisfied the audit objectives for the procurement compliance requirement. Finally, DCAA did not qualify its audit report to state that DCAA could not determine whether it could rely on the DLA work. Although DLA agreed to include procedures in its scope to meet the OMB Circular A-133 audit requirements for procurement and suspension and debarment, DCAA neither reviewed DLA's work nor qualified the report because DLA did not provide its working papers to DCAA.

Effect on the Audit

The DCAA auditors did not audit the procurement and suspension and debarment compliance requirement for the SwRI fiscal year 1999. Because auditors determined that the procurement requirement materially affects the research and development program,

¹⁶ At the time of the DCAA audit, DLA was part of the Defense Contract Management Command (DCMC). As of 2001, the Defense Contract Management Agency was formed from DCMC and now performs the purchasing system reviews for SwRI.

the audit was incomplete without an audit of this requirement. In addition, Federal agencies and other report users could not rely on the report opinion on compliance because DCAA did not audit a major program requirement.

We planned to recommend that the Regional Director, Central Region, Defense Contract Audit Agency, require its auditors to audit the procurement and suspension and debarment compliance requirement in accordance with OMB Circular A-133 and its related Compliance Supplement for the fiscal year 1999 and future year audits, including determining the extent of reliance that can be placed on the work of DLA. However, the DCAA auditors completed corrective action for the audit after our quality control review but before issuance of the draft report. Therefore, we consider corrective action sufficient, and we make no recommendations to address work performed to support reliance on the work of others.

Management's Comments. Concur. DCAA responded that the SwRI suboffice adequately followed DCAA guidance to document the reliance placed on the DLA¹⁷ review of SwRI's purchasing system. The DCAA Contract Audit Manual (CAM) Appendix D, Section D-302, provides specific guidance on evaluating and using the work of government technical specialists. The CAM does not require the DCAA auditor to specifically review the DLA team's working papers as a prerequisite for placing reliance on its work. In fact, the CAM states that the auditor will use the work of the specialist unless findings are obviously unrealistic or procedures used appear to have been inadequate.

In accordance with the guidance, the DCAA's working papers documented the (1) auditor's understanding of the work of the DCMA contractor purchasing system review (CPSR) team and (2) degree of reliance the auditor placed on the DCMA CPSR, including the impact on the audit results. DCAA coordinated with the DLA team at the beginning of the DLA review to ensure the review would include the procurement and suspension and debarment compliance requirement. Based on DCAA discussions with the DLA team and review of the team's report, DCAA concluded that the team adequately covered this compliance requirement, and DCAA had no reason to believe that the findings were unrealistic or that procedures used were inadequate.

In response to our draft of this report, the SwRI suboffice coordinated with the DLA team leader and reviewed applicable working papers to resolve the issue discussed in this finding. DCAA provided the NASA OIG with documentation of its review of the working papers. DCAA Headquarters, Policy and Plans will coordinate with the NASA OIG on the issue of reviewing DCMA CPSR team working papers (see Appendix F).

Evaluation of Management's Comments. OMB Circular A-133 §___.500(a) requires the auditors to perform an audit in accordance with GAGAS. GAGAS paragraph 1.9 incorporates the AICPA auditing standards by reference. The DCAA guidance is similar to the AICPA Codification of Statements on Auditing Standards section 336, "Using the

¹⁷ DCAA refers to DCMC in its response to the draft of this report. DLA is part of DCMC. See footnote 16.

Work of a Specialist.” The DCAA guidance encourages auditors to use the work of the Government specialist based on documenting the working papers for the (1) auditors’ understanding of the work performed by the specialist after reviewing the specialist’s report and (2) the degree of reliance the auditor placed on the specialist’s technical evaluation. In contrast to the DCAA guidance, the AICPA guidance states the auditors should review the specialist’s qualifications and working papers.

During our quality control review, the DCAA Auditor-in-Charge explained that he contacted the DLA reviewer who agreed to include certain steps in the DLA CPSR review to satisfy an audit of the procurement and suspension and debarment compliance requirement in accordance with OMB Circular A-133. The Auditor-in-Charge obtained and reviewed a copy of the DLA audit program to ensure it included the appropriate audit steps. However, the DCAA working papers contain no evidence that the auditors determined the qualification of the DLA reviewer or that DCAA reviewed DLA’s work. The Auditor-in-Charge had requested a review of DLA’s working papers but, as of the date of our quality control review, DLA had not provided them.

In addition, the DLA report does not state that the review was also performed to meet the auditing requirements for the procurement compliance requirement in accordance with OMB Circular A-133. Therefore, without the DCAA auditor’s review of the DLA working papers, there is no assurance in the DCAA working papers that DLA performed the work to meet the OMB Circular A-133 requirements. Nevertheless, DCAA has implemented corrective action.

Finding D. Opinion on the Schedule of Expenditures of Federal Awards

DCAA was responsible to opine on whether the Schedule of Expenditures of Federal Awards is presented fairly in all material respects to the financial statements taken as a whole, as required by OMB Circular A-133 §___.505 (a) and AICPA SOP 98-3 §5.1. However, the DCAA auditors did not document their working papers for the reconciliation of the Schedule of Expenditures of Federal Awards to the financial statements. The auditors assumed they had performed and documented the reconciliation in another assignment. As a result, there was no working paper documentation to support the auditors' opinion. Therefore, Federal agencies and other report users could not rely on the audit report opinion that the Schedule of Expenditures of Federal Awards is presented fairly. During the quality control review, the auditors presented evidence to us that they had performed the reconciliation but did not include the evidence in the working papers.

Reconciliation Requirement

OMB Circular A-133, §___.300(d), requires the auditee to prepare a Schedule of Expenditures of Federal Awards. AICPA SOP 98-3, §5.5, requires the auditee to reconcile the amounts presented in the financial statements to the related amounts in the Schedule. OMB Circular A-133, §___.505(a), and AICPA SOP 98-3, §5.1, require the auditor to determine and opine on whether the Schedule is presented fairly in all material respects to the financial statements taken as a whole.

DCAA Audit Effort

Although DCAA was responsible for opining on the Schedule of Expenditures of Federal Awards, the auditors did not prepare a working paper to support their opinion that the Schedule was fairly presented in relation to the financial statements taken as a whole.

To meet the OMB Circular A-133 audit requirements, DCAA audited the SwRI incurred cost submission, which identifies actual costs by Federal award and then by cost element. DCAA segregated the incurred cost submission into several audits by cost element, for example, other direct cost, labor, and material. The auditors reconciled the cost elements from the general ledger and trial balance to the accounting records. In addition to the individual audits, DCAA established an assignment to perform general reconciliations of the general ledger to the incurred cost submission, income tax returns, and the financial statements. The auditors presumed the Schedule would reconcile to the financial statements as part of this assignment. DCAA auditors completed the general reconciliations on February 24, 2000, but they did not receive the final Schedule of Expenditures of Federal Awards until June 2000. The final Schedule included Federal and non-Federal expenditures of about \$160 million. SwRI reported total Federal and non-Federal revenue in the 1999 financial statements of about \$304 million of which \$170 million was Federal revenue and \$134 million was commercial revenue. DCAA

auditors explained that, based on the expenditures in the financial statements and their knowledge of SwRI, the \$160 million in the Schedule represents only Federal awards. Nevertheless, the auditors did not reconcile the expenditures in the SwRI Schedule to the financial statements as of June 2000.

During the quality control review, the auditors provided a reconciliation of the accounting records to the Schedule of Expenditure of Federal Awards. The DCAA auditors had performed the reconciliation but did not include the evidence in the working papers. The auditors then amended the working papers to include the reconciliation.

Effect on the Audit

Federal agencies and other report users would not be able to rely on the audit report opinion that the Schedule of Expenditures of Federal Awards is presented fairly in all material respects to the financial statements taken as a whole without performing the necessary audit procedures.

We planned to recommend that for the fiscal year 1999 audit, DCAA auditors perform the necessary auditing procedures to support their opinion on whether the Schedule of Expenditures of Federal Awards is presented fairly in all material respects to the financial statements taken as a whole. However, the auditors completed corrective action for the audit during the quality control review. Therefore, we consider corrective action sufficient, and no recommendations address work performed to support an opinion on the Schedule in relation to the financial statements.

Recommendations, Management Response, and Evaluation of Response

We recommend that the Regional Director, Central Region, Defense Contract Audit Agency, require auditors who perform OMB Circular A-133 audits to:

- 5. Document their working papers for the reconciliation of the Schedule of Expenditures of Federal Awards to the contractor's incurred cost submission.**
- 6. Document the reconciliation between the Schedule and the financial statements.**

DCAA's Response. Concur. The SwRI suboffice performed procedures to reconcile the Schedule of Expenditures of Federal Awards to the accounting records, financial statements, and incurred cost submission. DCAA agreed that the working paper documentation could be improved and provided the OIG the revised working paper documentation for review.

DCAA will ensure that future fiscal year audits at SwRI include adequate working paper documentation on the reconciliation of the Schedule of Expenditures of Federal Awards to the accounting records, financial statements, and incurred cost submission (see Appendix F).

Evaluation of Management's Response. DCAA's completed corrective actions are responsive to the recommendations and are sufficient to close the recommendations for reporting purposes.

Finding E. Internal Auditors' Documentation of Internal Control Tests

The DCAA auditors relied on the internal auditors' work; however, DCAA had not ensured that the internal auditors adequately documented their working papers for their internal control testing for the matching and level of effort, reporting, and special tests and provisions compliance requirements. This occurred because DCAA did not adequately review the internal auditors' working papers. Without adequate documentation, Federal agencies and other report users could not rely on the audit report assurances related to internal control without oral explanations. During our quality control review, the internal auditors completed the required working paper documentation.

Documentation Requirements

The AICPA Codification of Statements on Auditing Standards §339.05, "Content of Working Papers," and GAGAS, sections 4.34 through 4.37, "Working Papers," require auditors to retain a record of the audit in the form of working papers to demonstrate that the applicable standards of field work have been met. GAGAS further state that the form and content of the working papers should allow an experienced auditor to understand the auditor's significant conclusions and judgments. In general, the working papers should document the objectives, scope, and methodology, including the sampling criteria the auditors used. Specifically, working papers should include enough information about the work performed and the documents (transactions and records) examined so that an experienced auditor would be able to examine the same documents to understand the auditors' conclusions and judgments.

Audit Requirements

The June 24, 1997, revision of OMB Circular A-133 describes the audit scope in §__.500. In general, the auditors are required to plan the audit to meet the following required internal control and compliance objectives:

- Plan the testing of internal control for each major program to support a low assessed level of control risk for the assertions relevant to the compliance requirements.
- Perform the planned internal control testing.
- Determine whether the audited organization has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of the major programs audited.

Internal Audit Oversight Requirements

Internal auditors from nonprofit organizations are specifically excluded from the OMB Circular A-133 definition of an auditor. Therefore, internal auditors may not issue OMB Circular A-133 reports. As a result, DCAA must review and accept the internal auditors' work as its own and issue OMB Circular A-133 reports. AICPA Codification of Statements on Auditing Standards §322.08 through .11 require auditors to assess the

competency and objectivity of the internal auditors when the internal audit work may affect the nature, timing, and extent of the auditing procedures. Sections .23 through .26 require the auditor to evaluate, through testing, the quality and effectiveness of the internal auditor's work when the work is expected to affect the audit procedures. The auditor's evaluation should consider such factors as whether the internal audit scope will meet the objectives, adequacy of the audit programs, working paper documentation, and the conclusions reached. Section 322.27, "Using Internal Auditors to Provide Direct Assistance to the Auditor," states:

In performing the audit, the auditor may request direct assistance from the internal auditors. This direct assistance relates to work the auditor specifically requests the internal auditors to perform to complete some aspect of the auditor's work. For example, internal auditors may assist the auditor in obtaining an understanding of internal control or in performing tests of controls or substantive tests, consistent with the guidance about the auditor's responsibility When direct assistance is provided, the auditor should assess the internal auditors' competence and objectivity ... and supervise, review, evaluate, and test the work performed by internal auditors to extent appropriate in the circumstances. The auditor should inform the internal auditors of their responsibilities, the objectives of the procedures they are to perform, and matters that may affect the nature, timing, and extent of audit procedures, such as possible accounting and auditing issues. The auditor should also inform the internal auditors that all significant accounting and auditing issues identified during the audit should be brought to the auditor's attention.

The Defense Contract Audit Manual contains similar guidance about using the work of other auditors.

Internal Audit Work

The DCAA auditors reviewed and approved the audit programs that the SwRI internal audit department used to complete the sections of the audit DCAA assigned to the SwRI audit department. In addition, DCAA reviewed the internal auditors' conclusions and judgments for each of the compliance requirements to determine whether DCAA agreed with the internal auditors' opinion on compliance. However, the DCAA review of the internal audit work did not identify deficiencies in the internal audit working paper documentation.

The internal auditors included comments in the audit programs related to internal controls and referenced working papers to support the comments. However, the referenced working papers did not include documentation to support the comments the SwRI internal auditors had in their audit programs. The internal auditors explained to us that they reviewed the internal controls as they performed the compliance testing, but they had not adequately documented their working papers to support the review. Through an oral explanation from the SwRI internal auditors, the independent reviewers understood the work that the internal auditors performed and how the work related to the comments in their audit programs.

Effect on the Audit

DCAA did not ensure that the internal auditors documented their internal control testing for the compliance requirements that have a direct and material effect on the research and development program. Consequently, independent reviewers could not determine whether the internal auditors tested internal controls as required by OMB Circular A-133. Also, the internal auditors did not document their working papers to support the internal control assurances in the audit report. Therefore, Federal agencies and other report users could not rely on the audit report assurances related to internal controls.

We planned to recommend that for the fiscal year 1999 audit, the DCAA auditors not place reliance on the work of the SwRI Internal Auditor Department unless they document their working papers to support internal control testing for each compliance requirement within the internal auditors' scope. However, the internal auditors completed corrective action for the fiscal year 1999 audit during our quality control review. Therefore, we consider corrective action sufficient, and no recommendation addresses the fiscal year 1999 audit.

Recommendation, Management Response, and Evaluation of Response

- 7. We recommend that for future years' audits, the DCAA auditors not place reliance on the work of the SwRI Internal Auditor Department unless the internal auditors document their working papers to support internal control testing for each compliance requirement within the internal auditors' scope.**

Management's Response. Concur. DCAA reviewed the SwRI Internal Audit Department's working papers relating to the internal auditors' work on understanding and testing internal controls so that DCAA could rely on the SwRI work. DCAA agreed that the internal auditors' working paper documentation for internal controls could be improved. The internal auditors revised the working papers relating to obtaining an understanding and testing of internal controls for the compliance requirements they reviewed. The internal auditors provided the OIG the revised working papers for review.

DCAA will ensure that future fiscal year audits at SwRI include adequate working paper documentation to support that DCAA can rely on the internal control work of the SwRI Internal Auditor Department for each compliance requirement within the internal auditors' scope (see Appendix F).

Evaluation of Management's Response. DCAA's completed corrective action is responsive to the recommendation and is sufficient to close the recommendations for reporting purposes.

Appendix A. Single Audit Requirements

The Inspector General Act of 1978, as amended (Public Law 95-452), requires an agency's Inspector General to "take appropriate steps to assure that any work performed by non-Federal auditors complies with the standards established by the Comptroller General."

The Single Audit Act of 1984 (Public Law 98-502) was intended to improve the financial management of state and local governments, while the Office of Management and Budget (OMB) Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," was intended to improve financial management for nonprofit organizations. The Act and the Circular established uniform requirements for audits of Federal financial assistance, promoted efficient and effective use of audit resources, and helped to ensure that Federal departments and agencies rely on and use the audit work to the maximum extent practicable.

The Single Audit Act Amendments of 1996 (Public Law 104-156) incorporate the previously excluded nonprofit organizations. Including the nonprofit organizations strengthens the usefulness of the audits by establishing one uniform set of auditing and reporting requirements for all Federal award recipients that are required to obtain a single audit. Major changes to the Act include: (1) increasing the audit threshold from \$25,000 to \$300,000 with respect to Federal financial assistance programs before an audit is required; (2) selecting Federal programs for audit based on a risk assessment rather than the amount of funds involved; and (3) improving the contents and timeliness of single audits.

The revised OMB Circular A-133 was issued on June 24, 1997, pursuant to the Single Audit Act Amendments of 1996. In general, the Circular requires that an auditee who expends \$300,000 or more annually in Federal awards, obtain an audit and issue a report of its Federal award expenditures in accordance with GAGAS applicable to financial audits. The audit must be performed by auditors who meet the independent standards in GAGAS and in accordance with the auditing and reporting requirements of the Circular and its related Compliance Supplement. The audit report submission contains:

- financial statements and related opinion,
- Schedule of Expenditures of Federal Awards and related opinion,
- report on the internal controls and compliance review of the financial statements,
- report on internal controls reviewed and compliance opinion on major programs, and
- Schedule of Findings and Questioned Costs.

The auditee must also submit a Data Collection Form to the Federal Audit Clearinghouse. The form summarizes the significant information in the audit report for dissemination to the public through the Internet. Responsible officials from the audited entity and the audit organization sign the form certifying to the information presented.

The Compliance Supplement is based on the requirements of the Single Audit Act Amendments of 1996 and the final June 30, 1997, revision of OMB Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits. The National State Auditors Association study states:

The Compliance Supplement provides an invaluable tool to both Federal agencies and auditors in setting forth the important provisions of Federal assistance programs. This tool allows Federal agencies to effectively communicate items which they believe are important to the successful management of the program and legislative intent

Compliance with the Supplement satisfies the requirements of OMB Circular A-133. The Supplement identifies Federal programs by Federal agency. The Supplement identifies existing and important compliance requirements, which the Federal Government expects the auditors to consider as part of an audit required by the 1996 Amendments. Using the Supplement eliminates the need for the auditors to research the laws and regulations for each major program audit to determine the compliance requirements that are important to the Federal Government and that could have a direct and material effect on the major program. The Supplement is a more efficient and cost-effective approach to performing this research. As stated in the Supplement, it "... provides a source of information for auditors to understand the Federal program's objectives, procedures, and compliance requirements relevant to the audit as well as audit objectives and suggested audit procedures for determining compliance with the requirements."

For single audits, the Supplement replaces agency audit guides and other audit requirement documents for individual Federal programs and specifically states which of the following 14 compliance requirements are applicable to a major program that may be audited:

1. Activities Allowed or Unallowed
2. Allowable Costs/Cost Principles
3. Cash Management
4. Davis-Bacon Act
5. Eligibility
6. Equipment and Real Property Management
7. Matching, Level of Effort, Earmarking
8. Period of Availability of Federal Funds
9. Procurement and Suspension and Debarment

Appendix A

10. Program Income
11. Real Property Acquisition/Relocation Assistance
12. Reporting
13. Subrecipient Monitoring
14. Special Tests and Provisions

The Compliance Supplement assists the auditors in determining the audit scope for the Circular's internal control requirements. For each compliance requirement, the Supplement describes the objectives of internal control and certain characteristics that when present and operating effectively, may ensure compliance with program requirements. The Supplement gives examples of the common characteristics for the 5 components of internal controls (control environment, risk assessment, control activities, information and communication, and monitoring) for the 14 compliance requirements.

Appendix B. Objectives and Scope

Audit Report Review

Our objective for the audit report review was to determine whether the report submitted by the auditee meets the applicable reporting standards and the Office of Management and Budget (OMB) Circular A-133, “Audits of States, Local Governments, and Non-Profit Organizations,” reporting requirements. As a Federal funding agency to Southwest Research Institute (SwRI), we performed a review of the audit report on SwRI for the fiscal year ended September 24, 1999. We reviewed the report for compliance with the requirements of the Single Audit Act, Single Audit Act Amendments of 1996, and OMB Circular A-133. We focused our review on the report’s qualitative aspects of: (1) due professional care; (2) auditor’s qualifications and independence; (3) financial statements, compliance, and internal control reporting; (4) Schedule of Expenditures of Federal Awards; and (5) Schedule of Findings and Questioned Costs.

Quality Control Review

Our objectives for the quality control review were to ensure that the audit was conducted in accordance with generally accepted government auditing standards¹⁸ and generally accepted auditing standards and whether the audit met the auditing and reporting requirements of OMB Circular A-133. As a Federal funding agency for the SwRI, we conducted quality control reviews of the Ernst & Young LLP and the Defense Contract Audit Agency (DCAA) audit working papers. We focused the review on the audit’s qualitative aspects of:

- auditor’s qualifications,
- independence,
- due professional care,
- quality control,
- planning and supervision,
- Federal receivables and payables,
- major program determination, and
- internal controls and compliance testing for major programs

We also focused the review on the working paper support for the:

- Schedule of Expenditures of Federal Awards,
- follow-up on prior quality control review findings,
- Schedule of Findings and Questioned Costs, and
- data Collection Form.

¹⁸These standards are broad statements of the auditors’ responsibilities, promulgated by the Comptroller General of the United States.

Appendix B

We organized our review by the general and field work audit standards and the required elements of a single audit. We emphasized the areas of major concern to the Federal Government such as determining and auditing major program compliance and internal controls. We conducted the review February 28 through March 7, 2001, at the San Antonio, Texas, office of Ernst & Young LLP and the SwRI suboffice of DCAA. The NASA Office of Inspector General has previously performed quality control reviews of Ernst & Young LLP and DCAA at other locations.

Peer Review Reports

We reviewed the November 3, 1998, report on the most recent peer review of Ernst & Young LLP, performed by KPMG Peat Marwick LLP. The KPMG Peat Marwick LLP review determined that Ernst & Young LLP met the objectives of the quality control review standards established by the American Institute of Certified Public Accountants and that Ernst & Young LLP complied with the standards during the fiscal year ended June 30, 1998.

We reviewed the September 27, 2000, external quality control report of DCAA, performed by the Office of Inspector General, Department of Defense (OIG, DOD). The OIG, DOD determined that there were no material, uncorrected noncompliances with applicable auditing standards or audit policies and procedures for DCAA fiscal years 1997 through 1999.

Appendix C. Quality Control Review Methodology

Report of Independent Auditors

The auditors are required to determine whether the financial statements are presented fairly in all material respects in conformity with generally accepted auditing principles and are free of material misstatement. The auditors are also required to subject the Schedule of Expenditures of Federal Awards to the procedures applicable to the audit of the financial statements and to ensure that the amounts are fairly stated in relation to the basic financial statements. We reviewed the Ernst & Young LLP audit programs for accounts receivable and accounts payable and the evidence to determine whether testing was sufficient based on an assessment of control risk to warrant the conclusion reached. We also reviewed the working papers to determine whether they supported the conclusion.

Schedule of Expenditures of Federal and Non-Federal Awards

The recipient is responsible for creating the Schedule of Federal Awards. The auditors are required to audit the information in the Schedule to ensure it is fairly presented in all material respects in relation to the financial statements taken as a whole. We reviewed the Defense Contract Audit Agency (DCAA) audit programs for the appropriate procedures and traced some of the amounts to the Subsidiary Ledger and/or Trial Balance.

Report on Compliance and on Internal Control over Financial Reporting Based on an Audit of the Financial Statements in Accordance with Government Auditing Standards

The auditors are required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect in determining financial statement amounts. The auditors are also required to obtain an understanding of internal controls that is sufficient to plan the audit and to assess control risk. We reviewed the Ernst & Young LLP audit programs for the appropriate procedures, the working paper documentation, and the compliance and substantive testing performed for accounts receivable and accounts payable.

Report on Audit of Southwest Research Institute's Compliance with Requirements Applicable to Major Program and on Internal Control Over Compliance in Accordance with OMB Circular A-133, Contractor Fiscal Year 1999

The auditors are required to determine whether the recipient has complied with laws, regulations, and the provisions of contracts and grant agreements that may have a direct and material effect on each of its major Federal programs. The auditors are required to use the procedures in the Office of Management and Budget Circular A-133 Compliance

Appendix C

Supplement to determine the compliance requirements for each major program. We reviewed the audit program for the appropriate procedures and compared the audit program steps to those in the Compliance Supplement to determine whether the applicable steps had been performed. We also reviewed the working paper documentation and its support and the compliance tests performed.

The auditors must perform procedures to obtain an understanding of internal controls over Federal programs that is sufficient to plan an audit to support a low-assessed level of control risk for major programs. The auditors must plan and perform internal controls testing over major programs to support a low level of control risk for the assertions relevant to the compliance requirements for each major program. We reviewed the audit programs for the appropriate procedures, the working paper documentation, and the test of controls performed.

Schedule of Findings and Questioned Costs

The auditors are required to prepare a Schedule of Findings and Questioned Costs that summarizes the audit results. This schedule includes information about and related to the audit that is not required to be identified in other parts of the audit report including: (1) major programs audited, (2) details on findings and questioned costs (including reportable conditions and material weaknesses), (3) dollar threshold to identify major programs, and (4) whether the recipient is considered to be low risk. We reviewed the audit programs for the appropriate procedures and the working paper documentation supporting the information in the schedule.

Summary Schedule of Prior Audit Findings

The auditee is required to prepare a Summary Schedule of Prior Audit Findings that reports the status of all audit findings from the prior audit's Schedule of Findings and Questioned Costs related to Federal awards. The auditor is required to review the Summary Schedule of Prior Audit Findings and report as a fiscal year 1999 finding instances in which the Summary Schedule of Prior Audit Findings materially misrepresents the status of any prior audit finding. We reviewed the audit programs for the appropriate procedures and the working paper documentation that support the review.

Appendix D. Follow-up on Department of Defense Office of Inspector General Finding and Recommendation

On September 11, 1998, the Department of Defense (DOD) Office of Inspector General (OIG) issued report number PO 98-6-017, “Quality Control Review of Ernst & Young LLP and the Defense Contract Audit Agency, Southwest Research Institute, Fiscal Year Ended September 27, 1996.” The auditors identified an immaterial finding related to the Defense Contract Audit Agency (DCAA) and a material finding related to Ernst & Young LLP. The auditors recommended corrective action on the Ernst & Young LLP finding only. During our quality control review, we determined whether the Ernst & Young LLP completed the recommended corrective action and whether the DCAA completed the self-imposed corrective action. Our review results follow:

Immaterial Finding – Inadequate Reporting on Specific Requirements

Finding. The DOD OIG report states that the DCAA “Report on Audit of Incurred Costs for SwRI,” September 24, 1997, does not refer to the specific requirements of eligibility; matching, level of effort, and/or earmarking; special reporting; and special tests and provisions. Paragraph 13(c)(5) of the Attachment to Office of Management and Budget (OMB) Circular A-133 and its associated Compliance Supplement require that the auditor determine whether those compliance requirements were met. Based on the DOD OIG review of the DCAA audit working papers, the DOD OIG determined that SwRI was in compliance with the specific requirements. However, the DOD OIG could not draw that conclusion by reading the report because DCAA did not identify the requirements in the report.

The DOD OIG has been working with DCAA to correct the audit report deficiencies; therefore, the report contains no recommendations regarding this finding. Nevertheless, DCAA agreed to train its auditors in the standard audit reporting requirements of OMB Circular A-133.

Status of Corrective Action. The auditors met the generally accepted government auditing standards for continuing professional education and obtained training specifically related to OMB Circular A-133.

Material Finding – Inadequate Audit Reporting

Finding. The DOD OIG report states that the financial statement audit report of SwRI prepared by Ernst & Young LLP for the fiscal year ended September 27, 1996, does not contain a reference to generally accepted government auditing standards (GAGAS). Additionally, the OIG concluded that the report did not address internal controls and compliance in accordance with GAGAS at the financial statement level.

Appendix D

The Attachment to the April 1990 version of OMB Circular A-133, paragraph 12(a), requires that the audit be conducted in accordance with GAGAS. Paragraph 5.11 of GAGAS requires that financial statement audit reports state that the audit was conducted in accordance with GAGAS. Paragraph 5.15 of GAGAS requires that the audit report on financial statements either describe the scope of the auditors' testing of compliance with laws and regulations and internal controls and present the results of those tests or refer to separate reports containing that information.

The DOD OIG concluded that the financial statement audit report did not appropriately cover internal controls and compliance because SwRI personnel did not properly coordinate the audit to ensure that either Ernst & Young LLP or DCAA covered each of the required reporting elements. DOD also concluded that the engagement letter of agreement (contract) between Ernst & Young LLP and SwRI did not identify the required reporting elements.

Recommendation for Corrective Action. The DOD OIG recommended that the SwRI obtain an audit report from Ernst & Young LLP that references GAGAS and addresses internal controls and compliance in accordance with GAGAS at the financial statement level.

Status of Corrective Action. The auditors issued the required GAGAS report related to the financial statements for the SwRI fiscal year 1999.

Appendix E. Other Matters of Interest

During our report and quality control reviews, we identified issues related to reporting and working paper documentation that should be brought to the attention of Southwest Research Institute (SwRI) and the Defense Contract Audit Agency (DCAA) but do not affect the results of our reviews. The issues are described below:

Notes to the Schedule of Expenditures of Federal Awards. Office of Management and Budget (OMB) Circular A-133, § ____.310(b)(4), requires SwRI to submit explanatory notes to the Schedule of Expenditures of Federal Awards. The 1999 audit report included an explanatory paragraph preceding the Schedule that described the reporting period covered, how the information was sorted, and the composition of the expenditures (direct labor, materials, indirect expenses, other direct costs). OMB Circular A-133 requires the auditee to include notes to the Schedule that describe the significant accounting policies used to prepare the Schedule. Future audit reports should include explanatory notes that describe the information required by OMB Circular A-133.

Corrective Action Plan. OMB Circular A-133, § ____.315(c), requires the auditee to prepare a corrective action plan that addresses each audit finding included in the fiscal year 1999 auditor's report. The 1999 corrective action plan addressed DCAA's finding related to property but did not address the finding regarding costs for legal proceedings. SwRI did not think it was necessary to address the costs because they were immaterial to the organization overall. During our review, SwRI agreed that the audit report does not clearly state the Institute's position to accept the questioned costs. Future audit reports should include a corrective action plan that addresses all findings.

Material and Applicable Compliance Requirements. OMB Circular A-133, § ____.500(d)(1) and (3), require the auditors to determine, through an audit of the compliance requirements, whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The DCAA auditors identified in their working papers the compliance requirements that do not apply to SwRI. However, the auditors should document the reason the requirement does not apply. That is, the auditor should state that the requirement is immaterial or that SwRI does not engage in that type of activity.

Prior Audit Findings. OMB Circular A-133, § ____.510(a)(7), requires the auditor to assess the reasonableness of the summary schedule of prior audit findings to ensure it materially represents the status of prior audit findings. Through the DCAA auditors' oral explanation of the information contained in the audit file, we determined that DCAA performed procedures to assess whether the schedule was materially represented. However, in future audits, the follow-up procedures must be documented to allow an independent reviewer to understand the work DCAA performed to meet this audit requirement.

Appendix E

Documentation of Materiality. Generally accepted government auditing standards, section 4.6, requires the auditor to consider materiality when planning the audit procedures and evaluating the results of those procedures. American Institute of Certified Public Accountants Statement of Position 98-3, sections 3.35 and 6.14, state that materiality for Federal programs is in relation to each major program audited and should be determined for each major program. DCAA did not document its working papers for materiality related to the major program. Future working papers must include this documentation.

Appendix F. Defense Contract Audit Agency Response



IS REPORT REPORT ID

DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8735 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6214

PQA 225.5

October 17, 2001

Mr. Alan J. Lamoreaux
Assistant Inspector General for Auditing
Office of Inspector General
National Aeronautics and Space Administration, Headquarters
Washington, DC 20546-0001

SUBJECT: Comments on Draft Quality Control Review Report - Assignment #A-01-015-00

Dear Mr. Lamoreaux:

Thank you for the opportunity to respond to the referenced draft report. We also appreciate the extension of time you gave us to submit a written response, and your willingness to have Ms. Vera Garrant of your staff evaluate the DCAA actions taken in response to your recommendations.

Enclosure 1 is our response to the five findings and recommendations contained in the draft report. We have improved the documentation in the working papers and permanent file to provide a more clear and concise support of the audit work performed. We also supplemented DCAA's audit report to incorporate the results of the assist audit and to reflect the current status of awards not audited. Ms. Garrant has reviewed the revised working papers and supplemental audit report. The problems identified by your draft report have been corrected, and DCAA's audit report may be relied upon by Federal agencies and other users.

Enclosure 2 is suggested wording changes to your draft report. The suggested changes make the comments consistent with other findings where corrective action had already been taken, and correctly identify a previously issued DCAA audit guidance memorandum referred to in your report.

If you have any questions, please contact me at (703) 767-3280 or Marc Parvin, Program Manager at (703) 767-2250. Our e-mail addresses are larry.uhlfelder@dcaa.mil and marc.parvin@dcaa.mil.

Sincerely,

A handwritten signature in cursive script that reads "Robert D. Marini".

FOR Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Enclosures: 2
a/s

Enclosure 2
is available
upon request.

Appendix F

**CENTRAL REGION
DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
6321 CAMPUS CIRCLE DRIVE EAST
IRVING, TX 75063-2742**

RQA-3 225.4

October 15, 2001

Mr. Alan J. Lamoreaux
Assistant Inspector General for Auditing
Office of Inspector General
National Aeronautics and Space Administration, Headquarters
Washington, DC 20546-0001

SUBJECT: Comments on Draft Quality Control Review Report
Assignment No. A-01-015-00

Dear Mr. Lamoreaux:

Thank you for the opportunity to respond to the draft report on the quality control review of the Ernst & Young LLP and Defense Contract Audit Agency audit of Southwest Research Institute (SwRI) for the fiscal year (FY) ended September 24, 1999. We also appreciate the extension of time you gave us to submit a written response and your willingness to have Ms. Vera Garrant of your staff evaluate the DCAA actions taken in response to your findings and recommendations.

We have improved the documentation in the working papers and permanent file to provide a clear and concise support of the audit work performed. We have also revised the qualification paragraph in the audit report to incorporate the assist audit and to reflect the current status of awards not yet audited. Ms. Garrant has reviewed the revised working papers and supplemental audit report and stated that the findings in the draft report have been corrected and the DCAA audit report now can be relied upon by Federal agencies and other users. We also discussed the draft report recommendations with Ms. Garrant and she agreed that the focus of these recommendations should be to ensure that future year audits at SwRI include procedures to adequately address the FY 1999 quality control review findings. As discussed with Ms. Garrant, we have made the suggested changes to the draft report (see Enclosure 2) to reflect these actions and discussions.

The following are comments on the quality control review findings and recommendations.

Finding A. Internal Control Documentation and Testing.

The DCAA field audit office (FAO) did obtain an independent understanding of the internal control system and performed necessary testing of relevant internal controls. We agree that the working papers could be improved to better document the steps taken

Enclosure 1

See Appendix H,
OIG Comments
1 through 4*

Recommendations
1 and 2.

* The referenced Enclosure 2 is not included in this report, but is available for review upon request.

RQA-3 225.4
 SUBJECT: Comments on Draft Quality Control Review Report
 Assignment No. A-01-015-00

October 15, 2001

to obtain the understanding of and test internal controls. For example, the working paper references relating to obtaining the understanding of internal controls on the internal control checklist also combined references relating to testing the internal controls. We improved the working paper documentation by summarizing the relevant internal controls upon which reliance was placed, and ensuring that the working paper references were more specific. We provided this revised documentation to your office and understand that the finding has been resolved.

We will ensure that future year audits at SwRI adequately document the auditor's understanding and testing of internal controls for applicable compliance requirements.

Finding B. Reporting Results of the Assist Audit.

The FAO issued the initial report on August 28, 2000. At the time of report issuance, the FAO had not yet received the assist audit. The initial report included a qualification on the awards not audited, but did not mention the assist audit that was not yet received. We issued a supplemental audit report on August 13, 2001 to incorporate the assist audit that was received after August 28, 2000, and to update the qualification on awards not yet audited. We provided a copy of the supplemental audit report to your office and understand that the finding has been resolved. We have proposed suggested wording to NASA's quality control review draft report (see Enclosure 2) to make the comments consistent with the other findings where corrective action has already been taken and reviewed by your office.

We will ensure that future fiscal year audit reports at SwRI include appropriate qualifications on assist audits not received and awards that were not audited. We suggest that you review the security ramifications of some of the wording in the draft report relating to this finding. Of the \$13.8 million mentioned in the draft report, the FAO audited \$6.8 million of indirect costs. The costs initially not audited were the remaining \$7 million of direct costs. The assist audit covered about \$5 million of the \$7 million. SwRI is responsible for obtaining the audit on the remaining \$6.5 million of direct costs.

Finding C. Relying on the Work of Others to Test Procurement and Suspension and Debarment.

We believe that the FAO adequately followed DCAA guidance in documenting the reliance placed on the Defense Contract Management Agency's (DCMA) review of SwRI's purchasing system. The DCAA Contract Audit Manual (CAM) Appendix D, Section D-302 provides specific guidance on evaluating and using the work of government technical specialists. In accordance with the guidance, the working papers did document (1) the auditor's understanding of the work of the DCMA contractor purchasing system review (CPSR) team, and (2) the degree of reliance the auditor placed on the DCMA CPSR, including the impact on the results of audit. We coordinated with the team at the beginning of their review to ensure the review would cover the procurement and suspension and debarment compliance requirement. Based on discussions with the team and review of the team's report, we believe the team

Recommendations 3 and 4

See Appendix H, OIG Comment 5

See Finding C

Appendix F

RQA-3 225.4
SUBJECT: Comments on Draft Quality Control Review Report
Assignment No. A-01-015-00

October 15, 2001

adequately covered this compliance requirement. The CAM does not require the DCAA auditor to specifically review the DCMA team's working papers as a prerequisite for placing reliance on their work. In fact, the CAM states that the auditor will use the work of the specialist unless findings are obviously unrealistic, or procedures used appear inadequate. In the case of the DCMA CPSR team, we had no reason to believe the findings were unrealistic or the procedures used were inadequate.

In response to the draft quality control finding, the FAO did coordinate with the DCMA team leader and reviewed applicable working papers to resolve the finding in the draft report. The documentation of this coordination and review of working papers was provided to your office and we understand the finding has been resolved. We will forward the issue of reviewing DCMA CPSR team working papers to DCAA Headquarters, Policy and Plans, for coordination with your office.

You may also want to consider mentioning in your report that DCMA is now a separate agency and is responsible for performing CPSRs.

Finding D. Opinion on the Schedule of Expenditures of Federal Awards.

The FAO did perform procedures to reconcile the Schedule of Expenditures of Federal Awards to the accounting records, financial statements, and incurred cost submission. We agree that the working paper documentation relating to the reconciliation could be improved. We made improvements to the working papers and provided the revised documentation to your office. We understand that finding has been resolved.

We will ensure that future fiscal year audits at SwRI include adequate working paper documentation on the reconciliation of the Schedule of Expenditures of Federal Awards to the accounting records, financial statements, and incurred cost submission.

Finding E. Internal Auditors' Documentation of Internal Control Tests.

The FAO did review the SwRI Internal Audit Department's working papers relating to their work on understanding and testing internal controls so that reliance could be placed on their work. We agree that the internal auditor's working paper documentation on the audit of internal controls could be improved. The internal auditors revised the working papers relating to obtaining an understanding and testing of internal controls for the compliance requirements they reviewed. These revised working papers were provided to your office, and we understand that the finding has been resolved.

We will ensure that future fiscal year audits at SwRI include adequate working paper documentation to place reliance on the internal control work of the SwRI Internal Auditor Department for each compliance requirement within the internal auditors' scope.

See Appendix H,
OIG Comment 6

Recommendations 5 and 6.

Recommendation 7.

RQA-3 225.4
SUBJECT: Comments on Draft Quality Control Review Report
Assignment No. A-01-015-00

October 15, 2001

Thank you again for working with our FAO on the findings and the opportunity to comment on the draft report. If you have any questions, please contact me at (972) 753-2513, or David Eck, Regional Audit Manager at (972) 753-2519. Our email addresses are frank.summers@deaa.mil and david.eck@deaa.mil.

Sincerely,

/signed/

FRANCIS P. SUMMERS, Jr.
Regional Director

Appendix G. Southwest Research Institute Response

SOUTHWEST RESEARCH INSTITUTE™

6220 CALLEPIA ROAD • POST OFFICE DRAWER 2810 • SAN ANTONIO, TEXAS 78228-2810, USA • (214) 664-5111 • WWW.SWRI.ORG

SENT VIA FAX--202-358-3251

October 17, 2001

Mr. Alan J. Lamoreaux
Acting Assistant Inspector General for Audits
Office of the Inspector General
National Aeronautics and Space Administration
Headquarters
Washington, DC 20546-0001

Re: Draft Report on the Quality Control Review of Ernst & Young
LLP And Defense Contract Audit Agency Audit of Southwest
Research Institute for the Fiscal Year Ended September 24,
1999
Assignment No. A-01-015-00

Dear Mr. Lamoreaux:

Reference is made to the e-mail revision at enclosure 1 to
Recommendation 4 of the referenced draft report that was received
earlier this month.

Southwest Research Institute (SWRI) will contact its cognizant
audit agency to coordinate the required audit activities and
responsibilities among the auditor parties and classified auditees
and SWRI concurs with the revised draft recommendation. By so
doing and continuing to work with our Security Department, we will
attempt to obtain assurance that any federal funds in these
programs are properly expended.

Sincerely,


J. S. Fernandi
Controller

Enclosure



DETROIT, MICHIGAN (248) 353-0559 • HOUSTON, TEXAS (713) 877-1377 • WASHINGTON, DC (202) 881-2226

Recommendation 4*

*The referenced Enclosure 1 is not included in this report, but is available for review upon request.

Appendix H. OIG Comments on Defense Contract Audit Agency Response

The Defense Contract Audit Agency (DCAA) provided the following general comments as Enclosure 1 in its response to our draft report. This appendix also addresses editorial comments DCAA made to the draft report and included them as Enclosure 2 in its response (see Appendix F). Our responses to these comments are also presented.

DCAA Comment. DCAA suggested wording for this report to reflect that certain auditing deficiencies existed at the time of the quality control review, but that the conditions have been corrected to the satisfaction of the Office of Inspector General (OIG). In addition, the recommendations should be directed to the Regional Director, Central Region, instead of the Director, DCAA.

1. OIG Comments. The narrative in both our draft and final reports accurately reflects the condition of DCAA's working papers and the audit procedures as of the last day of our field work. The final report addresses the status of all corrective actions. We have redirected the recommendations to the Regional Director, Central Region, DCAA and have included the Director, DCAA in our distribution.

DCAA Comment. DCAA recommended that we revise the *Internal Control Testing* paragraph in Finding A to state that the auditors did not adequately document the internal control testing performed for the fiscal year 1999 audit or complete the checklist sections related to internal control testing.

2. OIG Comments. We agree that the DCAA auditors did not adequately document their working papers to support that internal control testing had been performed. Our evaluation of management's comments on recommendation 2 addressed this issue.

DCAA Comment. The report's reference to PIC 730.5.5.1, "Audit Guidance on Limitation of Audit Scope When Performing an OMB [Office of Management and Budget] Circular A-133 Audit," in Finding B should be Memorandum for Regional Directors (MRD) 98-PIC-150(R).

3. OIG Comments. We revised the report accordingly.

DCAA Comment. Revise the condition statement in the first paragraph of Finding C to include "adequately": "*The DCAA auditors did not adequately plan, execute, and document the annual review....*"

4. OIG Comments. We revised the condition statement in the first paragraph accordingly. During our quality control review, we determined that the auditors had planned to review the Defense Logistics Agency (DLA) working papers, but were unable to execute and document the result of the planning process because the DCAA auditors could not obtain the working papers for review.

Appendix H

DCAA Comment. DCAA suggested that the NASA OIG review the security ramifications of some of the wording in the draft report related to Finding B. Of the \$13.8 million in classified costs discussed in the draft of the report, DCAA’s Southwest Research Institute (SwRI) suboffice audited \$6.8 million of indirect costs. The remaining \$7.0 million of direct costs was initially not audited. The DCAA Field Detachment¹⁹ audit included about \$0.5 million of the \$7.0 million. SwRI is responsible for obtaining an audit on the remaining \$6.5 million of direct costs.

5. OIG Comments. Prior to issuing our draft report, DCAA expressed concern about the term “classified” in our report to identify sensitive awards. The Department of Defense (DOD) is the cognizant agency for audit for SwRI. Therefore, we had discussed using the term with a DOD OIG representative, who explained that the DOD OIG uses the term and that we could also. Therefore, we did not use another term to identify the sensitive awards.

We reviewed the DCAA Field Detachment report that identified the amount of expenditures audited. We agree with the amounts DCAA identified in its response and revised Finding B accordingly.

DCAA Comment. The NASA OIG may also want to consider mentioning in the report that the Defense Contract Management Command Agency (DCMA) is now a separate agency and is responsible for performing contractor purchasing system reviews (CPSR’s).

6. OIG Comments. We contacted the DCAA Headquarters, Office of Policy and Plans, which explained that at the time of the DCAA audit, the specialist organization was called the Defense Contract Management Command (DCMC) and included the DLA. Early in 2001, DCMA gained independence from DCMC and now performs the CPSR’s. We included this information in footnote 16 in Finding C.

¹⁹ See footnote 14.

Appendix I. Report Distribution

Audit Firm/Auditor

Mr. David King, Partner
Ernst & Young LLP
100 West Houston Street, Suite 1900
San Antonio, TX 78205

Mr. William H. Reed, Director
Defense Contract Audit Agency
8725 John J. Kingman Road, Suite 2345
Fort Belvoir, VA 22060-6219

Mr. Francis Summers, Regional Director
Central Region
Defense Contract Audit Agency
6321 Campus Circle Drive East
Irving, TX 75063-2742

Mr. Lawrence P. Uhlfelder
Assistant Director, Policy and Plans
Defense Contract Audit Agency
8725 John J. Kingman Road, Suite 2353
Fort Belvoir, VA 22060-6219

Mr. Jerry McAfee, Branch Manager
Defense Contract Audit Agency
Arlington Branch
1201 North Watson Road, Suite 174
Arlington, TX 76006-6223

Audited Organization

Mr. Jack S. Fernandi, Controller
Southwest Research Institute
6220 Culebra Road
San Antonio, TX 78228

Federal Offices of Inspector General

Department of Agriculture
Department of Defense
Department of Energy

Appendix I

Federal Offices of Inspector General (Cont.)

Department of Health and Human Services
Department of the Interior
Department of the Treasury
Department of Transportation
Environmental Protection Agency
Federal Emergency Management Agency
National Science Foundation
Nuclear Regulatory Commission

National Aeronautics and Space Administration (NASA) Officials-in-Charge

A/Administrator
AA/Chief of Staff
AB/Associate Deputy Administrator for Institutions
B/Acting Chief Financial Officer
B/Comptroller
BF/Director, Financial Management Division
G/Acting General Counsel
H/Associate Administrator for Procurement
JM/Director, Management Assessment Division
L/Associate Administrator for Legislative Affairs

NASA Field Installation

John H. Glenn Research Center at Lewis Field
Goddard Space Flight Center
Langley Research Center
George C. Marshall Space Flight Center

Executive Office of the President

Office of Management and Budget, Office of Federal Financial Management

NASA Assistant Inspector General for Auditing Reader Survey

The NASA Office of Inspector General has a continuing interest in improving the usefulness of our reports. We wish to make our reports responsive to our customers' interests, consistent with our statutory responsibility. Could you help us by completing our reader survey? For your convenience, the questionnaire can be completed electronically through our homepage at <http://www.hq.nasa.gov/office/oig/hq/audits.html> or can be mailed to the Assistant Inspector General for Auditing; NASA Headquarters, Code W, Washington, DC 20546-0001.

Report Title: Quality Control Review of Ernst & Young LLP and Defense Contract Audit Agency Audit of Southwest Research Institute for Fiscal Year Ended September 24, 1999 (Assignment No. A-01-015-00)

Report Number: _____ **Report Date:** _____

Circle the appropriate rating for the following statements.

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	N/A
1. The report was clear, readable, and logically organized.	5	4	3	2	1	N/A
2. The report was concise and to the point.	5	4	3	2	1	N/A
3. We effectively communicated the audit objectives, scope, and methodology.	5	4	3	2	1	N/A
4. The report contained sufficient information to support the finding(s) in a balanced and objective manner.	5	4	3	2	1	N/A

Overall, how would you rate the report?

Excellent Fair Very Good Poor Good

If you have any additional comments or wish to elaborate on any of the above responses, please write them here. Use additional paper if necessary.

How did you use the report?

How could we improve our report?

How would you identify yourself? (Select one)

- | | |
|---|--|
| <input type="checkbox"/> Congressional Staff | <input type="checkbox"/> Media |
| <input type="checkbox"/> NASA Employee | <input type="checkbox"/> Public Interest |
| <input type="checkbox"/> Private Citizen | <input type="checkbox"/> Other: _____ |
| <input type="checkbox"/> Government: _____ Federal: _____ State: _____ Local: _____ | |

May we contact you about your comments?

____ Yes.
Name _____
Telephone Number: _____

____ No.

Thank you for your cooperation in completing this survey.

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